From: Brooke Emmerick
To: 'microsoft.atr(a)usdoj.gov'
Date: 1/28/02 4:58pm
Subject: Microsoft Settlement

BEFORE THE UNITED STATES DEPARTMENT OF JUSTICE

UNITED STATES OF AMERICA, Plaintiff, v. MICROSOFT CORPORATION, Defendant.	Civil Action No. 98-1232 (CKK)
STATE OF NEW YORK *ex rel.* Attorney General Eliot Spitzer, *et al.*, Plaintiffs, v. MICROSOFT CORPORATION Defendant.	Civil Action No. 98-1233 (CKK)

Comments of The Progress & Freedom Foundation on the Revised Proposed Final Judgment and the Competitive Impact Statement

Jeffery A. Eisenach, Ph.D.
President

Thomas M. Lenard, Ph.D.
Vice President for Research

THE PROGRESS &
FREEDOM FOUNDATION
1301 K. St., N.W.
Washington, D.C. 20005
(202) 289-8928
(202) 289-6079 Facsimile

Table of Contents

I. Introduction

These comments on the Proposed Final Judgment[1] ("PFJ") and the Competitive Impact Statement[2] ("CIS") in the Microsoft case are submitted to provide the Department of Justice ("DOJ") and the Court with information and analysis based on nearly five years of research by the authors on the legal, policy and economic implications of this landmark proceeding. Based on that research, it is our assessment that (a) the PFJ fails to address meaningfully the violations of law found by this court and upheld by the U.S. Court of Appeals and its entry by the court manifestly is not in the public interest; (b) the CIS fails to meet the standard of analysis demanded by the law and occasioned by the magnitude of the issues involved; and (c) the public interest will best be served through imposition of a "hybrid" structural remedy or, if the court chooses not to impose a structural remedy, a conduct remedy modeled after the proposals of the remaining litigating states.

A. The Authors

Dr. Eisenach is President and Senior Fellow at The Progress & Freedom Foundation, [3] a non-profit research and educational institution dedicated to analyzing the impact of the digital revolution and its implications for public policy, and an Adjunct Professor at George Mason University Law School. As a professional economist, he has been actively engaged in the analysis of competition and regulatory policy issues for more than 20 years, and has served in senior positions at the Office of Management and Budget and the U.S. Federal Trade Commission and as a consultant to the U.S. Sentencing Commission on criminal sentencing

---

[1] *United States v. Microsoft Corp.*, Stipulation and Revised Proposed Final Judgement (November 6, 2001) (hereafter "PFJ").

[2] *United States v. Microsoft Corp.*, Competitive Impact Statement (November 15, 2001) (hereafter "CIS").

guidelines for corporations. He has also served on the faculties of Harvard University's Kennedy School of Government, the University of Virginia and Virginia Polytechnic Institute and State University.

Dr. Lenard is Vice President and Senior Fellow at The Progress & Freedom Foundation and a professional economist with 30 years of experience in academia, government, private consulting and the non-profit sector. He has worked on a wide range of regulatory and antitrust issues covering a broad span of industries, and has consulted on antitrust cases for both private firms and the Federal Trade Commission. In government, he has held senior economic positions at the Council on Wage and Price Stability, the Office of Management and Budget and the Federal Trade Commission. A principal focus of his research has been the benefits and costs of regulatory interventions into the economy and the analytical underpinnings needed to make informed decisions about government interventions. Both Drs. Eisenach and Lenard have done extensive work on the economics of high-tech markets in general, and the Microsoft case in particular. They are co-authors of the annual *Digital Economy Fact Book,*[4] co-editors of *Competition, Innovation and the Microsoft Monopoly: Antitrust in the Digital Marketplace* and authors of numerous other papers on these and related topics.[5]

B. Summary of Comments

The PFJ is intended to settle the government's antitrust case against Microsoft and was agreed to by the United States, 9 of the 18 states that were also party to suit, and by Microsoft.

---

[3] These comments reflect the views of the authors and do not represent the views of The Progress & Freedom Foundation, its officers or board of directors.

[4] See Jeffrey A. Eisenach, Thomas M. Lenard and Stephen McGonegal, *The Digital Economy Fact Book 2001* (Washington: The Progress & Freedom Foundation, 2001).

[5] See Jeffrey A. Eisenach and Thomas M. Lenard, eds., *Competition, Innovation and the Microsoft Monopoly: Antitrust in the Digital Marketplace*, Kluwer Academic Publishers, 1999; Thomas M. Lenard, *Creating Competition in the Market for Operating Systems: A Structural Remedy for Microsoft,* (Washington: The Progress & Freedom Foundation, 2000), http://www.pff.org/remedies/htm; and Thomas M. Lenard, "Creating Competition in the Market

The nine remaining states and the District of Columbia (the "Litigating States") have not agreed to the PFJ and are pursuing more stringent relief through a remedy hearing at the District Court.[6] The DOJ is required by the Antitrust Procedures and Penalty Act ("APPA")[7] to prepare a CIS, which is intended to analyze the competitive implications of the PFJ and any alternatives to it.

The PFJ does not serve the public interest and will not achieve the government's objective that it "halt continuance and prevent recurrence of the violations of the Sherman Act by Microsoft that were upheld by the Court of Appeals and restore competitive conditions to the market."[8] Indeed, much of the behavior found by the Court of Appeals to be anticompetitive would be permitted under the PFJ. Further, even if the PFJ did preclude such behavior it would fail to restore competitive conditions because it fails to affect the behavior of participants in the marketplace.

The CIS does not satisfy the government's obligation to provide the District Court with an analytical basis for determining whether the PFJ is in the public interest. The APPA clearly requires, and good public policy demands, an "evaluation" of the proposed remedy and major alternatives to it. The CIS does not present such an evaluation. It does not explain why the PFJ will achieve the intended results, but merely asserts that it will do so. It also does not explain why the DOJ concluded that the PFJ will better serve the public interest than major alternatives, but merely states that "[t]he United States ultimately concluded that the requirements and prohibitions set forth in the Proposed Final Judgment provided the most effective and certain relief in the most timely manner."[9] The DOJ has produced no real analysis of the relative merits

---

for Operating Systems: Alternative Structural Remedies in the Microsoft Case," *George Mason Law Review*, Vol., 9, Spring 2001, 803-841.

[6] *United States v. Microsoft Corp.*, Plaintiff Litigating States' Remedial Proposals, (December 7, 2001) (hereafter "LS Proposal").

[7] 15 USCS 16 (b-h)

[8] CIS at 2.

[9] CIS at 63.

of alternative forms of relief to guide the District Court in deciding whether to approve the PFJ. Indeed, the CIS fails by a wide margin to meet the standards required of analyses of regulatory proposals routinely promulgated by government agencies.

Accordingly, the District Court should not accept the PFJ, but should, instead, expand its hearing on the Litigating States Proposal ("LS Proposal") to include the full range of major alternatives. This would permit the District Court to gather the information needed to make an informed judgment concerning which of the remedy proposals will best serve the public interest. The alternatives that should be considered include:

- The PFJ.
- The proposals of the Litigating States.
- Major structural remedies, including the vertical-divestiture remedy initially adopted by the District Court and the "hybrid" remedy proposed by Dr. Lenard and others.

Among these remedies, the "hybrid" structural approach would best serve the public interest and maximize net economic benefits to consumers.

In the sections that follow, we provide, first, a brief restatement of the facts and legal background in this case, including a brief discussion of what we believe to be the appropriate standards by which remedial action should be judged. Next we discuss the shortcomings in the PFJ and the CIS, explaining why the PFJ will not achieve the government's objectives or serve the public interest and demonstrating that the CIS falls far short of the analytical standard that should be demanded by the court. Finally, we turn to an evaluation of the remedial alternatives and explain why we believe that (a) a "hybrid" structural remedy would best serve consumers and competition and (b) that if the court chooses not to impose a structural remedy, the LS Proposal is superior to the PFJ.

II. Background: The Facts, the Law and the Remedy

The U.S. District Court[10] found, and the U.S. Court of Appeals[11] affirmed, a pattern of Sherman Act violations by Microsoft that had the effect of foreclosing competition in the market for personal computer operating systems. The District Court ordered a structural remedy, which was overturned by the Appeals Court, which remanded the remedy issue back to this court. The Appeals Court did not prescribe or prohibit adoption of any particular remedial actions by this court.

A. The Illegal Conduct and Its Effects

The Appeals Court unanimously affirmed the core of the government's case against Microsoft, finding that the company had undertaken a broad array of anticompetitive practices to maintain its monopoly in personal computer operating systems, in violation of Section 2 of the Sherman Act.[12] Microsoft's strategy was to use its monopoly power to prevent the emergence of any new technology that might compete with Windows. Microsoft's anticompetitive activities were particularly directed against two products—the Netscape browser and Sun's Java programming language—that could support operating-system-neutral computing and thereby erode Microsoft's market position. In summary, the District Court found, and the Appeals Court affirmed, that:

- Microsoft has monopoly power in the market for Intel-compatible PC operating systems, with a market share of greater than 95 percent. Microsoft's market is protected by a substantial barrier to entry—the "applications barrier to entry"—that discourages software developers from writing applications for operating systems that do not already have an established base of users.

---

[10] *United States v. Microsoft Corp.*, 84 F. Supp. 2d 9 (D.C.Circ 1999) ("*Findings of Fact*");*United States v. Microsoft Corp.*, 87 F. Supp. 2d 30 (D.C. Circ. 2000) ("*Conclusions of Law*").
[11] *United States v. Microsoft Corp.*, 253 F 3d, at 6 (D.C. Circ. 2001).

- Microsoft effectively excluded rival browsers from the two most efficient means of distribution—pre-installation by Original Equipment Manufacturers (OEMs) and distribution by Internet Access Providers (IAPs).

- Microsoft imposed restrictions on its Windows licenses that effectively prevented OEMs from pre-installing any browser other than Internet Explorer (IE).

- Microsoft's technological binding of IE to Windows deterred OEMs from pre-installing rival browsers and consumers from using them.

- Microsoft's contracts with IAPs—for example, agreeing to give AOL preferential placement on the Windows desktop in exchange for AOL's agreement not to distribute any non-Microsoft browser to more than 15 percent of its subscribers and to do so only at the customer's explicit request—blocked the distribution of a rival browser.

- Microsoft's deals with Independent Software Vendors (ISVs)—for example, giving preferential support to ISVs that used IE as the default browser in software they develop—and Apple—prohibiting Apple from pre-installing any non-Microsoft browser—were similarly exclusionary.

- Microsoft's agreements with ISVs that made receipt of Windows technical information conditional on the ISVs' agreement to use Microsoft's version of the Java Virtual Machine (JVM) exclusively were anticompetitive. Microsoft also deceived Java developers into believing that its tools were not Windows-specific and were consistent with Sun's objective of developing cross-platform applications.

- Microsoft's pressuring of Intel to stop supporting cross-platform Java—by threatening to support an Intel competitor's development efforts—was exclusionary.

Microsoft was clearly successful in its efforts to eliminate threats to its desktop monopoly. Through its anticompetitive activities, Microsoft achieved dominance in the browser market and forestalled the development of such cross-platform technologies as the Netscape browser and Java that could have eroded the applications barrier to entry. The promise of operating-system-neutral computing was that it would inject competition into the market for operating systems, which would foster innovation throughout the industry. By preventing the development of competition, Microsoft's illegal conduct thwarted innovation and harmed consumers.

B. Appropriate Criteria for a Remedial Action

The Supreme Court has stated that the purpose of remedial action in an antitrust case is to "terminate the illegal monopoly, deny to the defendant the fruits of its statutory violation and ensure that there remain no practices likely to result in monopolization."[13] In other words, a remedy must be effective in the present (terminating the monopoly), the past (expropriating ill-gotten gains), and the future (preventing similar conduct going forward).

As professional economists, we suggest it is especially important to look to the future, where economic actors will make decisions based on the incentives inherent in whatever remedy the court imposes. The remedy should not only address the illegal practices Microsoft already has employed to maintain its operating system monopoly, it should also—as the Supreme Court has said—address practices that Microsoft might employ in the future to erect barriers to operating system competition or to use anticompetitive practices to leverage its monopoly beyond the desktop into new phases of computing. In a business that moves as rapidly as the software marketplace (and other information technology and communications markets Microsoft is now entering or is likely to enter soon) it is particularly important that the remedy be forward looking.

The DOJ claims that the PFJ meets these standards, and "will eliminate Microsoft's illegal practices, prevent recurrence of the same or similar practices, and restore the competitive threat that middleware products posed prior to Microsoft's unlawful undertakings."[14] For reasons discussed at length below, we disagree. Here, we address two issues relating to the standard by which any remedy should be judged.

---

[13] 253 F 3d at 99-100, quoting (*United States v. United Shoe Mach. Corp*), 391 U.S. 244, 250 (1968).
[14] CIS at 3.

First, it is noteworthy that the DOJ does not claim the PFJ achieves the goal of denying Microsoft the fruits of its violations, and clearly it will not. Such restitution is important not only to "make whole" the victims of Microsoft's illegal activity (e.g., the United States), but also to establish appropriate incentives on a going forward basis. In general, allowing violators to retain the fruits of their illegal conduct deprives the antitrust laws of much of their force, because it sends a signal to violators that the returns to their behavior are positive—even when they are caught. With $42 billion in the bank, one wonders how Microsoft's senior management could read the proposed PFJ any other way.

Second, and relatedly, DOJ's stated goal of restoring "the competitive threat that middleware products posed prior to Microsoft's unlawful undertakings" is not the appropriate objective, and certainly is not equivalent to the Supreme Court's standard of "terminat[ing] the illegal monopoly." The competitive threat posed by the Netscape browser and Java was quantitatively relatively small at the time that Microsoft's illegal campaign against them was undertaken. But it was clear, certainly to Microsoft, that their competitive potential in the dynamic software marketplace was very significant. Had Microsoft not engaged in illegal activities, the competitive significance of these products would be much greater today than it was at the time.

There is a useful analogy here to simple commercial damage cases. If, for example, an individual or a company incurs monetary damages from actions in the past, compensation is generally based on the present value of those damages, typically calculated by bringing the damage amount forward (from the time of the damage to the present) at a normal rate of return. That would be the only way for the damaged party to be made whole. Similarly, society has been damaged by Microsoft's actions. For society to be made whole, competition should, to the

extent possible, be restored to what it would be today in the absence of Microsoft's illegal conduct.[15] Equally important on a going forward basis, however, Microsoft should not be permitted to earn continuing returns based upon its illegally enhanced monopoly position. To do so would be to allow the company not only to retain the fruits of its illegal conduct in the past but to *continue* harvesting those fruits indefinitely.

III. The CIS and the PFJ: Flawed Analysis of a Flawed Remedy

DOJ and Microsoft prefer a PFJ which contains a number of restrictions on Microsoft's conduct on a going forward basis. The questions before the court are whether entry of the PFJ is consistent with the purpose and intent of the Sherman Act and, in addition, whether, under the APPA, it is consistent with the public interest. To facilitate the court's deliberations on the latter issue, the APPA requires the DOJ to submit a CIS.[16] However, the CIS submitted in this proceeding contains virtually no analysis of either the PFJ or alternative remedies. It represents nothing more than a set of unsupported assertions, and accordingly should be given little deference by the court.

In this section, we briefly describe the main provisions of the PFJ. Next, we explain why the CIS fails to meet a reasonable standard of substantive analysis. Third, we provide some examples of shortcomings in the PFJ which would have been obvious had DOJ performed a more complete analysis in the CIS.

A. Major Provisions of the PFJ

As described in the CIS, the proposed PFJ contains seven major provisions. In brief summary, they are:

[15] To truly be made whole, society would in addition need to be compensated for the benefits it lost due to the absence of competition in the intervening years, which is probably not possible.

- OEMs would have the freedom to support and distribute non-Microsoft middleware products or operating systems without fear of retaliation by Microsoft.

- To help ensure against retaliation, Microsoft would be required to provide uniform licensing terms to the 20 largest computer manufacturers.

- Computer manufacturers would have the freedom to feature and promote non-Microsoft middleware and customize their computers to use non-Microsoft middleware as the default.

- Microsoft would be required to disclose the interfaces and technical information that its own middleware uses, so that ISVs can develop competitive middleware products.

- Microsoft would be required to disclose communications protocols necessary for server and Windows desktop operating system software to interoperate with each other.

- Microsoft would be prohibited from retaliating against ISVs or IHVs that develop or distribute software that competes with Microsoft middleware or operating system software.

- Microsoft would be prohibited from entering into exclusive contracts concerning its middleware or operating system products.

The CIS claims that these provisions, and the supporting provisions pertaining to enforcement, "will eliminate Microsoft's illegal practices, prevent recurrence of the same or similar practices, and restore the competitive threat that middleware products posed prior to Microsoft's unlawful undertakings." But the CIS presents virtually no analysis to support this claim.

B. The Competitive Impact Statement

The CIS does not meet the standards established by the APPA and does not provide sufficient analysis for this court to make an informed decision on whether the PFJ is in the public interest.

---

[16] CIS at 3-4.

Section 16(b)(3) of the APPA requires that the CIS include "an explanation of the proposal . . . and the anticipated effects on competition of such relief." (Emphasis added.) Section 16(b)(6) further requires "a description and evaluation of alternatives to such proposal actually considered by the United States." (Emphasis added). Under Section 16(e), the District Court is required to determine that the consent judgment is in the public interest and in making that determination "may consider...anticipated effects of alternative remedies...." Taken together, these provisions make clear that the CIS was intended by Congress to serve as a guide to the court in evaluating the proposed relief relative to other alternatives which might better serve the public interest, not simply as a pro forma set of claims and assertions. Yet the CIS in this case fails even to fully "explain," and certainly cannot be said to "evaluate," either the likely effects of either the PFJ or the available alternatives. Such an analysis would seem especially important in a fully-litigated Tunney Act case such as this one, where a prior finding of liability suggests a lower degree of deference to the PFJ than would otherwise be appropriate, and thus a higher burden on the court to evaluate alternatives.

How should the court evaluate the adequacy of the CIS? Three sets of criteria present themselves. First, does the CIS satisfy the plain language of the statute? Second, how does it compare with previous CIS's in similarly significant cases? Third, how does it compare with the standards of analysis that are required to be performed in similar situations, such as agency rulemakings? This CIS fails all three standards.

First, does the CIS satisfy the plain language of the statute? It depends on how the words "explain," and "evaluate" are defined. To defend successfully the plain-language adequacy of the CIS, the DOJ would have to adopt a very narrow interpretation of both words.

Granted, the CIS devotes 43 pages[17] to reciting and, DOJ presumably would argue, "explaining" the provisions of the PFJ. What the CIS does not do at any point, however, is explain "the anticipated effects [of the PFJ] on competition."

The semantic sleight of hand upon which DOJ relies to avoid this obligation is found on page 24 of the CIS. There, DOJ reminds us that "Restoring competition is the 'key to the whole question of an antitrust remedy,' *du Pont*, 366 U.S. at 326." Then it continues with a clever subterfuge: "Competition was injured in this case principally because Microsoft's illegal conduct maintained the applications barrier to entry....***Thus***, the key to the proper remedy in this case is to end Microsoft's restrictions on potentially threatening middleware. . . ."[18] (Emphasis added.)

There, in the word "thus," lies the sum and the entirety of the CIS's explanation of the connection between the PFJ and its anticipated effects on competition. For as explained in more detail below, it is hardly obvious, indeed, it is highly unlikely, that simply ending Microsoft's illegal restrictions on middleware would have any significant effect on competition on a going forward basis. Even in these semantically troubled times, we submit, the word "thus" cannot be taken as the "explanation" the law requires.

But the CIS's discussion of the PFJ must be counted an analytical masterpiece when compared with its treatment of alternative remedies. In contrast to the lengthy, if failed, treatment accorded the PFJ, the CIS attempts its "evaluation of alternatives" in three pages. Not surprisingly, given its brevity, the analysis is limited in how much light it can shed on the DOJ's decisionmaking process or the relative merits of the alternatives before the court. With respect to structural remedies, for example, the evaluation consists of 49 words: "After remand to the

[17] CIS, 17-60.
[18] CIS at 24.

District Court, the United States informed the court and Microsoft that it had decided, in light of the Court of Appeals opinion and the need to obtain prompt, certain and effective relief, that it would not further seek a breakup of Microsoft into two businesses."[19] Receiving even less attention are six other remedy alternatives, which are summarily dismissed in a single paragraph, and an unknown number of "others received or conceived" which, in apparent direct violation of the APPA, are not even described.[20] There simply is no semantic standard by which this treatment of the alternative remedies can possibly be considered "an evaluation."

In summary, the CIS submitted by the DOJ in this case fails the first test the court should apply: It does not fulfill the plain language requirements of either Section 16(b)(3) or Section 16(b)(6) of the APPA.

Any effort the DOJ may make to defend the CIS would be on firmer ground if it could argue it is simply following past practice. While we believe, as suggested above, that the CIS in this case should be held to a higher standard than in cases where the issues have not been fully litigated and a finding of liability has not been entered, at least the DOJ could claim it was adhering to precedent. Even by the standards of past cases, however, this CIS falls far short.

Of course, Tunney Act cases vary in significance and complexity. The best standard for comparison for this case would appear to be the CIS filed in the AT&T case in 1982.[21] In that case as in this one, DOJ was tasked with explaining and evaluating a Proposed Final Judgment aimed at resolving a continuing series of complex antitrust actions affecting one of the most important sectors, and companies, in the U.S. economy.

---

[19] CIS at 61.
[20] CIS at 63.
[21] *United States v. Western Electric Company, Inc. and American Telephone & Telegraph Company*, Competitive Impact Statement (February 17, 1982), 47 FR 7170-01. (Hereafter *AT&T* CIS). Of course, unlike this case, the PFJ in the AT&T case was entered prior to any finding of liability.

The *AT&T* CIS differs markedly from the CIS in this proceeding both in its explanation of the competitive effects and in its evaluation of alternative remedies. Section III of the *AT&T* CIS[22] presents a comprehensive explanation of the proposed remedy *and its anticipated effects on competition.* Indeed, in stark contrast to the CIS in this case, the *AT&T* CIS contains, in Section III.E, an extensive discussion specifically detailing "The Competitive Impact of the Proposed Modification." The section is a lengthy one, explaining in detail how each provision of the proposed remedy is expected to affect competition on a going forward basis, beginning as follows:

> Put in simplest terms, the functional divestiture contemplated by the proposed modification will remove from AT&T the power to employ local exchange services in ways that impede competition in interdependent markets, and will remove from the Bell Operating Companies ("BOCs"), which will retain such power, any incentive to exercise it. *The United States believes, therefore, that the modification's divestiture requirement, and its complementary injunctive provisions, will substantially accelerate the development of competitive markets for interexchange services, customer premises equipment, and telecommunications equipment generally.*[23]

The ensuing pages present a careful analysis of why the government believes this to be the case and what the precise impacts on competition are likely to be. The proposed remedy will "accelerate the emergence of competition in interexchange services,"[24] "prevent the reemergence of the . . . incentive and ability to leverage regulated monopoly power into the customer premises equipment market,"[25] make AT&T "subject to competition in all of its services,"[26] "remove the source of AT&T's monopoly power and its ability to leverage monopoly power into related markets,"[27] and "prevent the creation anew of incentives and

[22] *AT&T* CIS at 7173-7180.
[23] *AT&T* CIS at 7178.
[24] *AT&T* CIS at 7178.
[25] *AT&T* CIS at 7179.
[26] *AT&T* CIS at 7179.
[27] *AT&T* CIS at 7179.

abilities in the BOCs to use their monopoly power to undercut rivals in competitive markets."[28] "There is every reason to believe that, divested of the BOCs, AT&T will be a procompetitive force in the markets that it enters. As a result of the modification, it is likely that AT&T will expand not only its product lines, but also the areas in which it sells telecommunications equipment."[29]

The authors have searched in vain, as will the court, for any similar explanation in the Microsoft CIS. As a procedural matter, the absence of such explanations flies in the face of the APPA. As a substantive one, it strongly suggests such statements are lacking for the simple reason that they are not justified by the remedy Microsoft and the DOJ are asking the court to adopt.

The *AT&T* CIS also differs from the one in this case in its treatment of alternative remedies.[30] The *AT&T* CIS appears to meet the requirements of the APPA by describing in some detail the alternative remedies considered *and evaluating their likely impacts on competition relative to those expected from the one proposed.* "The United States believes," it concludes, "that the [main alternative] did not approach even remotely the effectiveness of the proposed modification in achieving conditions that would assure full competition in the telecommunications industry."[31] Again, such evaluative language is simply absent from the CIS in this case. And again, one cannot help but conclude that, had today's DOJ conducted the same careful analysis as that conducted 20 years ago, it might well have reached different conclusions in the current case.

---

[28] *AT&T* CIS at 7179.
[29] *AT&T* CIS at 7179.
[30] *AT&T* CIS at 7181.
[31] *AT&T* CIS at 7181.

In summary, then, the CIS not only fails the satisfy the plain language of the APPA, but also fails to meet the standard established by DOJ for a CIS in the most directly analogous case.

The third criteria by which the court should evaluate the sufficiency of the CIS is whether it meets the standards of analysis that are required to be performed in similar situations, the most obvious of which is agency rulemakings.

For at least the last 20 years, agencies have been required to undertake a detailed regulatory impact analysis when they propose major regulatory actions. Under E.O. 12291 (in effect during the Reagan and Bush Administrations), and E.O. 12866 (issued by President Clinton and still in effect), government agencies have been expected to prepare a detailed analysis of the expected benefits and costs of major regulatory proposals and alternatives to them.[32] While the PFJ is technically not a regulation that would fall under E.O. 12866, the magnitude of its impact far exceeds the $100 million threshold that defines a "major rule" and thus triggers the requirement for a detailed analysis.

The analysis of regulatory interventions in the economy, which is what the PFJ in this case is, is not a black art. Increasingly, and on the basis of more than two decades of performing such analyses of all major rules, regulatory analysis has become a scientific process comprised of distinct steps and containing specific elements. E.O. 12866, for example, lays out specific criteria such analyses should meet, including: "(i) An assessment, including the underlying analysis, of benefits anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets . . . .) together with, to the extent feasible, a quantification of those benefits; (ii) An assessment, including the underlying analysis, of costs anticipated from the regulatory action . . . together with, to the extent feasible, a quantification of those costs; and (iii) An assessment, including the underlying

analysis, of the costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation. . . ."

The specific analytical techniques to be used in such evaluations are further described in guidance from the Office of Management and Budget issued January 11, 1996,[33] and reiterated most recently by OMB on June 19, 2001.[34] These guidelines require agencies, before issuing any major regulation, to take into account such issues as whether more "performance oriented" approaches are possible, the impact of alternative levels of stringency and effective dates, and alternative methods of ensuring compliance, and to perform evaluations that take into account "discounting," "risk and uncertainty," and "non-monetized benefits and costs." Each analysis, the guidance demands, must "provide information allowing decisionmakers to determine that: There is adequate information indicating the need for and consequences of the proposed action; The potential benefits to society justify the potential costs . . . ; The proposed action will maximize the net benefits to society . . . ; [and] . . . . Agency decisions are based on the best reasonably available scientific, technical, economic, and other information."

The requirements of the APPA with respect to Competitive Impact Statements are, of course, far less specific than those listed above. But the purpose of the APPA in requiring a CIS is presumably similar to the purpose of regulatory analyses: To allow decisionmakers, in this case the court, to understand the ramifications of their actions relative to alternative choices. By the standards of modern policy analysis, DOJ's CIS fails to perform this function at the level the court should expect, especially in a case of this magnitude.

---

[32] See E.O. 12291 (February 17, 1981) and E.O. 12866 (September 30, 1993).

[33] Office of Management and Budget, *Economic Analysis of Federal Regulations Under Executive Order 12866* (January 11, 1996)(available at www. whitehouse.gov/omb/inforeg/riaguide.html).

[34] Office of Management and Budget, *Memorandum for the Heads of Executive Departments and Agencies: Improving Regulatory Impact Analyses* (June 19, 2001)(available at www.whitehouse.gov.omb/memoranda/m01-23.html)

To repeat what we asserted at the outset of this section, the court might evaluate the CIS in this case by three standards: First, does the CIS satisfy the plain language of the statute? Second, how does it compare with previous CIS's in similarly significant cases? Third, how does it compare with the standards of analysis that are required to be performed in similar situations, such as agency rulemakings? This CIS fails all three standards.

C. The PFJ Will Not Have Its Claimed Effect, Nor Any Pro-Competitive Effect

In fact, a close reading of the language of the PFJ indicates that it will not do what the DOJ claims. Moreover, even if DOJ's claims are taken at face value, the PFJ will not have its intended effect because of the realities of the marketplace. Indeed, this is the only conclusion that can be reached based upon a real analysis of the "competitive impact" of the PFJ, which is to say an analysis of how, if at all, the provisions of the PFJ will change the behavior of participants in the marketplace.

Other commentators will undoubtedly thoroughly catalogue the loopholes in the PFJ, of which there are many, and it is not our intention to do so here. It is, however, illustrative of the defects of the PFJ to analyze it through the lens of the Netscape browser experience, since so much of Microsoft's liability concerns its actions toward the Netscape browser. Accordingly, much of the PFJ is directed at precluding the type of anticompetitive acts that Microsoft undertook against Netscape (even though the browser war is over and the industry has now moved on to a different stage). But, the PFJ does not even succeed in this minimal goal—of creating the conditions under which the Netscape browser could have competed without being subject to Microsoft's exclusionary practices. Indeed, the PFJ specifically permits many of the exclusionary practices in which Microsoft engaged:

- Section III.A of the PFJ is supposed to protect OEMs from retaliation by Microsoft if they distribute non-Microsoft products. However, the language of Section III.A prohibits Microsoft from retaliating against an OEM for "developing, distributing, promoting, using, selling, or licensing any software that competes with Microsoft Platform Software or any product or service that distributes or promotes any Non-Microsoft Middleware." (Emphasis added). (Microsoft Platform Software is defined as including (i) a Windows Operating System Product and/or (ii) a Microsoft Middleware Product.) While the Netscape browser was a potential competitor for the Microsoft operating system, it never became an actual competitor. Moreover, at the time Netscape introduced its browser, Microsoft did not have a comparable Middleware Product. Thus, the language of III.A would have permitted Microsoft to retaliate against OEMs for distributing the Netscape browser at the time it was introduced.
- Similarly, Section III.F.1 prohibits Microsoft from retaliating against any ISV or IHV for "developing, using, distributing, promoting or supporting any software that competes with Microsoft Platform Software or any software that runs on any software that competes with Microsoft Platform Software...." (Emphasis added). The prohibitions in Section III.F.2 on Microsoft's relations with ISVs are also triggered by software that "competes with Microsoft Platform Software", which the Netscape browser did not initially do.
- Section III.G.2 is intended to prevent similar exclusionary behavior with respect to IAPs and ICPs, by prohibiting Microsoft from entering into any agreement with "any IAP or ICP that grants placement on the desktop or elsewhere ... on the condition that the IAP or ICP refrain from distributing, promoting or using any software that competes with

Microsoft Middleware." (Emphasis added). Again, Netscape's browser was a new product that did not compete with any Microsoft product at the time it was introduced.

- Section III.C is intended to prevent restrictive agreements with OEMs by, for example, preventing Microsoft from restricting the ability of its OEM licensees from "[l]aunching automatically ...any Non-Microsoft Middleware if a Microsoft Middleware Product that provides similar functionality would otherwise be launched...." (See Section III.C.3, emphasis added). Under this language, Microsoft can preclude its OEM licensees from permitting the automatic launch of a new product if Microsoft does not have a similar product or if the Microsoft product does not have "similar functionality" (obviously, a term open to interpretation). Again, when the Netscape browser was launched, Microsoft did not have a similar product.
- Section III.D is intended to preclude Microsoft from excluding rival products by denying them the technical information they need to interoperate with the Windows operating systems. It requires Microsoft to "disclose to ISVs, IHVs, IAPs, ICPs, and OEMs, for the sole purpose of interoperating with a Windows Operating System Product ... the APIs and related Documentation that are used by Microsoft Middleware to interoperate with a Windows Operating System Product." (Emphasis added). If, however, Microsoft does not produce an analogous product, it might not use the APIs needed for a new application, such as the Netscape browser, to get started.
- Section III.H contains a variety of provisions designed to enable choice of Non-Microsoft Middleware Products on the part of users and OEMs. The PFJ explicitly states, however, that "Microsoft's obligations under this Section III.H as to any new Windows Operating System Product shall be determined based on the Microsoft Middleware Products which

exist seven months prior to the last beta test version (i.e., the one immediately preceding the first release candidate) of that Windows Operating System Product." At the time the Netscape browser was introduced, there was no comparable Microsoft Middleware Product.

- Finally, Non-Microsoft Middleware Products are defined to include products "of which at least one million copies were distributed in the United States within the previous year." (Section VI.N). Thus, regardless of any of the other provisions, the PFJ permits exclusionary behavior against new products that are trying to get established.

In sum, under the provisions of the PFJ Microsoft would have been permitted to engage in anticompetitive practices against the Netscape browser because the browser did not compete against the Windows operating system and because Microsoft did not at the outset have a comparable product. Moreover, at least in the early stages, the Netscape browser would not have been covered because a million copies had not been distributed in a single year. The DOJ obviously feels that the fabled entrepreneurs of Silicon Valley, working in their garages, are not worthy of protection against Microsoft under the PFJ. It is especially ironic that Microsoft, which has dedicated so much rhetoric to persuading the courts and the public that its monopoly could be overturned at any moment by the proverbial entrepreneur working out of her garage, should seek to preserve the right to squash precisely such competitive threats.

More broadly, the requirement that Microsoft have a comparable product in order to trigger some of the PFJ's provisions creates perverse incentives. It may discourage Microsoft from introducing its own product, because to do so triggers provisions restricting its ability to exclude a potential competitor. The result could be that consumers would be deprived entirely of a useful middleware product that might potentially compete with the Windows operating system,

because Microsoft is able to engage in exclusionary practices against another firm and does not find it in its interest to introduce its own product.

But the PFJ is flawed at an even deeper level: Even if it did what DOJ and Microsoft say it would, its effect on firms that operate in Microsoft's markets and its ability to restore competition in those markets would be minimal at most. Most of the PFJ is intended to prevent Microsoft from retaliating against OEMs, ISVs, IAPs and others that distribute, develop or otherwise support software that competes with Microsoft middleware. Under the terms of the PFJ, however, these entities would have little incentive to promote competitive middleware.

This is principally because, despite the Appeals Court ruling that Microsoft's integration of the browser and the operating system was anticompetitive, the PFJ would allow Microsoft to continue to bundle its middleware (and other) products with its operating system. Indeed, Microsoft's new XP software incorporates new functionality into the Windows operating system as never before. It includes, among other things, the IE browser, Microsoft's instant messaging and email software, Windows Media Player and the Microsoft Passport digital authentication software. All of these functions are bundled together and the combined package is sold at a fixed price.

Thus, OEMs have virtually no incentive to customize their offerings with non-Microsoft software. To do so involves an additional cost for the non-Microsoft software when compariable functionality is provided by Microsoft at no additional cost. An OEM that did this would have to pass these added costs on to its customers and would likely lose sales to other OEMs. Obviously, if OEMs don't have the incentive to install non-Microsoft software, ISVs won't have the incentive to develop it and IAPs won't have the incentive to distribute it.

As a result, the PFJ will not have any significant pro-competitive impact in the markets for either middleware or PC operating systems. Nor, for the same reasons, is it likely to have any significant pro-competitive impact on newly emerging markets, such as voice-over-IP instant messaging, game boxes, e-commerce technologies (e.g., "Passport") or digital rights management technologies. Indeed, the inability to make any plausible claims for such pro-competitive effects is the most likely explanation for the fact that, in contrast to the *AT&T* CIS, the CIS in this case doesn't make any.

IV. The Remedy Alternatives

There are two general classes of remedies that can be employed to remedy Microsoft's antitrust violations—conduct remedies and structural remedies. Conduct remedies leave Microsoft intact and attempt to constrain its anticompetitive behavior by imposing a set of behavioral requirements—essentially, a regulatory regime tailor-made for one firm. Microsoft's structure—and, importantly, its incentives—remain largely the same.[35] The challenge is to develop rules that effectively deter anticompetitive behavior, given that such behavior might continue to be in Microsoft's interest. The PFJ, which relies on conduct remedies, will not be effective in deterring anticompetitive behavior on the part of Microsoft.

Structural relief takes a different approach. Structural relief, as the name implies, involves restructuring the firm so as to change its incentives and ability to act anticompetitively. As DOJ explained eloquently in the *AT&T* CIS, if a restructuring is successful in achieving those goals, behavioral restrictions are largely unnecessary. The Appeals Court noted that structural

[35] Microsoft's incentives would be modified to the extent it faces legal penalties, but those penalties would have to be very large to have a significant effect on Microsoft's incentives.

relief is a common form of relief in antitrust cases and is "the most important of antitrust remedies."[36]

In this section, we describe the alternative structural remedies available to the court. Then we offer an evaluation of the proposals offered by the remaining litigating states.

A. Alternative Structural Remedies

At the government's urging, the District Court initially adopted a structural remedy, supplemented by interim conduct relief.[37] The Appeals Court vacated the District Court's remedy, partly because it modified the District Court's liability finding and partly because the District Court had failed to hold an evidentiary hearing.[38] The Appeals Court did not, however, rule out a structural solution to this case. The Court directed that "the District Court also should consider whether plaintiffs have established a sufficient causal connection between Microsoft's anticompetitive conduct and its dominant position in the OS market."[39] It continued, "[i]f the court on remand is unconvinced of the causal connection between Microsoft's exclusionary conduct and the company's position in the OS market, it may well conclude that divestiture is not an appropriate remedy."[40] This is an issue that should be explored in an evidentiary hearing. While it is difficult to predict exactly how the industry would have developed in the absence of Microsoft's anticompetitive behavior, it is likely that an alternative to Microsoft's operating-system platform would have emerged and it is a virtual certainty that Microsoft's position would be far less dominant than it is today. Clearly, Microsoft thought that was a distinct possibility.

The causation between Microsoft's anticompetitive practices and its operating system monopoly runs both ways. Without its monopoly, Microsoft would have been unable to engage

---

[36] 253 F 3d at 103, quoting *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 331 (1961).
[37] *United States v. Microsoft Corp.*, 97 F Supp-2d. (D.C.Circ. 2000) "Final Judgement".
[38] 253 F 3d at 6.
[39] 253 F 3d at 105.

in the exclusionary practices documented by the District Court and affirmed by the Appeals Court. Moreover, because of the wide array of business practices at issue and the complexity of the industry, it is very difficult to fashion a conduct relief regime that will be effective if Microsoft retains its dominant market position. This is why the Department of Justice (initially) and others (including ourselves) favor a structural solution. Two different forms of structural solution have been proposed, which we review in turn.

The DOJ initially proposed, and the District Court initially ordered, a vertical divestiture, which would divide Microsoft along product lines, into an operating systems company and an applications company.[41] The DOJ argued that this remedy would create two powerful companies that would have the incentive to compete with each other, diminishing the market power of both. According to Timothy Bresnahan, Chief Economist at the Antitrust Division at the time, "divestiture of the company into an applications and an operating system company restores competitive conditions very like those destroyed by the anticompetitive acts. Absent the anticompetitive acts, Microsoft would have lost the browser war, and other firms would have commercialized useful technologies now controlled by Microsoft. Divided technical leadership, which could be accomplished by having an independent browser company in the late 1990s or an applications company now, lowers barriers to entry and competition in many markets. It was exactly this route to an increase in competition that Microsoft avoided by its anticompetitive acts. Second, ending Microsoft's unique position in the industry offers innovative new technologies the choice of two mass-market distribution partners, either Appsco [the applications company] or OSCo [the operating system company]. The divestiture will do much to reduce the motive to violate and also to reduce the effectiveness of future anticompetitive acts. It restores

[40] 253 F 3d at 105-6..
[41] Final Judgement at 2.

conditions for competitive innovation at a moment in technology history [i.e., when the Internet is starting to be commercialized] when having a single firm set the direction of innovation in PC and end-user oriented internet markets is most unwise."[42]

Similarly, the Department of Justice, in initially proposing this remedy, argued that separating the operating system from the applications company would "reduce the entry barriers that Microsoft's illegal conduct erected and make it less likely that Microsoft [would] have the incentive or ability to increase them in the future."[43] An independent applications company would have every incentive to support competitors to Windows rather than make decisions based on the level of threat those competitors pose to Microsoft.[44] A separate applications company would have appropriate incentives to port its products to competing operating systems, such as Linux, thereby lowering the applications barrier to entry that potential competitors face. Currently, Microsoft has an incentive to strategically withhold applications from actual or potential competitors, even if providing them would otherwise be economically justified. In addition, the applications company would have the incentive to make its tools available to Independent Software Vendors (ISVs) that cooperate with competing operating system providers.

Separate operating system and applications companies would make it possible for middleware technologies in the applications company to be competitive with Windows. When applications are written to middleware technologies, like the Netscape browser, which operate between the applications software and the operating system, they become operating system-

---

[42] Timonthy F. Bresnahan, "The Right Remedy," at 1, (available at www.stanford.edu/~tbres/microsoft/The Right Remedy.pdf).
[43] Plantiffs' Memorandom in support of Proposed Final Judgement at 30-43, *Microsoft* (No. 98-1232), *available at* http://www.usdoj.gov/atr/cases/f4600/4640.htm.
[44] *United States v. Microsoft Corp.*, 147 F 3d 935 (D.C.Circ. 1998) Romer Declaration # 4, (hereafter Romer).

neutral,[45] reducing the applications barrier to entry and facilitating competition with Windows. There are several desktop applications, including Microsoft Office, that expose APIs and could become important middleware technologies.

Of course, a vertical divesture now would have a somewhat different effect than when it was first adopted by the District Court, because Microsoft has bundled many more applications into its new XP operating system. If the District Court again decided to adopt this remedy, it would also have to decide whether to require Microsoft to remove some applications functionality from its XP operating system or permit it to remain as is. If the XP operating system were allowed to remain as is, applications that would previously have been part of the applications company would be part of the operating system company. However, significant applications—principally, Microsoft Office—still remain separate from the operating system.

The alternative to a vertical approach is what we term a "hybrid" structural remedy, which combines both vertical and horizontal elements. A purely horizontal divestiture would divide Microsoft into several vertically integrated companies, each with full rights to Microsoft's intellectual property, creating several sellers of Windows as well as Microsoft's other software products. This remedy arguably goes beyond what is necessary or could be justified as matter of law, since it divides up products that were not the subject of the case.

A number of commentators, including Dr. Lenard, have proposed a "hybrid" remedy, which has elements of both vertical and horizontal divestiture.[46] It goes a step beyond the vertical divestiture remedy that the District Court adopted by first separating the operating

---

[45] Romer at 13.

[46] See Thomas M. Lenard, *Creating Competition in the Market for Operating Systems: A Structural Remedy for Microsoft*, (Washington: Progress & Freedom Foundation, 2000) http://www.pff.org/remedies/htm; Remedies Brief of Amici Curiae Robert E. Litan et al., 2000; Thomas M. Lenard, " Creating Competition in the Market for Operating Systems: Alternative Structural Remedies in the Microsoft Case," *George Mason Law Review*, Vol. 9., Spring 2001.

systems company from the applications company and then creating three equivalent operating system companies.

Microsoft's bundling of more applications functionality into the new XP operating system strengthens the arguments for the hybrid remedy relative to other remedies. The PFJ (as discussed above) does not contain any restrictions on bundling, which will hinder its effectiveness dramatically. In addition, as more applications are moved into the operating system, the vertical divestiture becomes less able to restore the competitive balance, because the newly formed applications company would be a less powerful competitor.

By creating competing Windows companies, the hybrid remedy directly addresses the monopoly problem, which is the source of Microsoft's anticompetitive behavior. As indicated above, without the monopoly, Microsoft would never have been able to exclude the Netscape browser from the most effective means of distribution—OEMs and IAPs. It would not, for example, have been able to get the OEMs to refrain from pre-installing the Netscape browser as a condition for receiving a Windows license. Similarly, Microsoft would not have been able to extinguish the market for a competing browser by bundling the Windows operating system with IE. Microsoft would not have been able to do these things—which are at the core of the Appeals Court's liability finding—because the OEMs and the IAPs would have had competitive alternatives to which they could turn.

The hybrid remedy would eliminate the applications barrier to entry for the new Windows companies and deprive Microsoft of its ability to leverage its desktop monopoly into new markets. Because it really does restore competition, extensive behavioral restrictions are not required, making this the least regulatory of the available alternatives.

The hybrid remedy is to a significant extent an "intellectual property" remedy, requiring Microsoft to grant full intellectual property rights to its Windows Operating System to two new companies. This type of remedy is particularly suited to "new-economy" companies like Microsoft, whose assets consist primarily of informational capital, which can easily be replicated.[47] The rationale for going further and dividing up employees is that much of the intellectual property is embodied in the employees.[48] In contrast to traditional "old-economy" companies, however, there is very little physical capital to be divided up.

This factor should alleviate some of the concerns expressed in the Appeals Court opinion about the use of a structural remedy in the case of a "unitary company"—i.e., a company not formed by mergers and acquisitions.[49] Such concerns have more validity in the case of old-economy companies, because of the difficulty of dividing up physical capital. What is being proposed in the hybrid remedy is much closer to a reproduction than it is to a division of the company's assets. When those assets consist primarily of information, they can be reproduced at very low cost.

B. The Litigating States Proposal

We believe a structural remedy continues to offer the best hope of deterring Microsoft's anticompetitive behavior in a way that is not overly regulatory. If, however, a structural remedy is off the table, the conduct remedy proposed by the Litigating States (LS) is far better than the PFJ. The LS Proposal does not contain the obvious loopholes and exceptions that are pervasive in the PFJ. Moreover, the LS Proposal includes a number of provisions that can partially restore competition to what it might have been absent the anticompetitive behavior. Because it will

---

[47] Remedies Brief of Amici Curiae Robert E. Litan et al., 2000.
[48] Thomas M. Lenard, *Creating Competition in the Market for Operating Systems: A Structural Remedy for Microsoft,*(Washington,: Progress & Freedom Foundation, 2000) http://www.pff.org/remedies/htm.
[49] 253 F 3d at 103.

change the behavior of the participants in the market, the LS Proposal provides a serious remedy to Microsoft's offenses. Some of the attractive features of the LS proposal are as follows:

- In contrast to the PFJ, the LS Proposal contains prohibitions on exclusionary and retaliatory behavior that are clear and unambiguous and mean what they purport to mean. In general, they provide meaningful protection against retaliation for the development and distribution of non-Microsoft software.
- The LS Proposal would require Microsoft to license an unbundled version of its software. As discussed above, the bundling of applications together with the monopoly operating system makes it uneconomic in most cases to develop and distribute software that competes with Microsoft. This requirement would address that problem and create an environment in which rival software can be developed.
- The LS Proposal would require Microsoft to license its software to third parties (not just OEMs) who could produce a customized product that would enlarge the range of consumer choice and provide competition for Microsoft.
- The proposal also would require Microsoft to continue to license predecessor versions of Windows. This would permit OEMs to expand the range of consumer choice by providing a lower-priced operating-system product that might be perfectly satisfactory for a large number of users. In addition, it would permit OEMs and third parties to continue to develop a differentiated product that might be competitive with Microsoft.
- The LS Proposal would require Microsoft to make IE available on an open-source basis, and would require Microsoft to distribute Java, thereby partially reversing some of the effects of Microsoft's illegal activities

- Finally, the LS Proposal would require Microsoft "to auction to a third party the right to port Microsoft Office to competing operating systems." This would reduce the applications barrier to entry for a competing operating system, such as Linux.

All of these aspects of the LS Proposal would add significantly to the probability that the remedy in this case would actually have the desired effect of increasing competition in one or more of the relevant product markets.

V. Conclusion

The PFJ is not an adequate remedy and its adoption is not in the public interest. It will not deter Microsoft from engaging in anticompetitive activities and it will not restore competition in this extremely important sector of the economy. Moreover, the CIS that the government has prepared does not provide the information necessary for the District Court to determine that the PFJ is in the public interest.

In order to generate the necessary information for such a determination, the District Court should hold an evidentiary hearing in which the competitive impacts, benefits and costs of all the available remedies are closely evaluated. In addition to the PFJ, the Court should consider structural remedies—which appear to be justified under the criteria established by the Court of Appeals—as well as the LS Proposal. We believe that at the end of this process, the court will agree that the PFJ is not in the public interest and that the "hybrid" structural remedy we recommend best meets all the of the criteria governing the court's deliberations in this matter.